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SUBJECT: MPs Buying Votes by Nationalizing Mongolia's "Strategic" Mining Assets?

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¶1. SUMMARY AND COMMENT: Mongolia's Parliament and Prime Minister S. Bayar's administration have, in post's view and that of western mining firms, embraced a decidedly anti-business set of mining amendments, likely to be passed during an upcoming recess session of Parliament. The amendments are poorly drafted, contain hints of possible expropriation and emerged through an exceptionally un-transparent process. Faced with the selective nationalization of key mining assets (vaguely defined "strategic" assets), several foreign and domestic mining firms have chosen to slow, suspend or cancel their operations in Mongolia. Aware of these impacts but facing re-election in June, MPs from both the ruling Mongolian People's Revolutionary Party (MPRP) and the opposition Democratic Party(DP) have apparently decided that they can't oppose populist legislation and survive the elections. So, they believe proving their love for Mongolia might be the ticket to electoral success. Post and mining firms have engaged in quiet efforts to lay the groundwork for a more market-oriented approach following the 2008 Parliamentary/2009 Presidential election cycle. END SUMMARY AND COMMENT.

KEY CONTROVERSIAL PROVISIONS

¶2. (SBU) An extraordinary session of Mongolia's Parliament will be convened on March 25 to consider a set of amendments to the controversial 2006 Law on Mineral Resources. The new amendments contain provisions that have generated intense concern among all stakeholders. The provisions are as follows. (Although the wording is rendered in tortured English, Post is loathe to change the text lest we alter the legislative drafters' intent.)

-- A. A "mineral deposit of strategic importance" means a deposit with "exceptional impact on national security, independence, economy and social development considering its reserve quantity, location, economic benefits and mineral classification."

-- B. "If the Mongolian Government, (a) Mongolian legal person or Mongolian citizen mines a mineral deposit of strategic importance in cooperation with a foreign legal entity, the foreign company's ownership percentage shall not exceed 49% of the equity."

-- C. "In its capacity as the owner of the deposit, and when granting mineral mining licenses, the State shall take in advance its percentage of the value of the deposit, according to the feasibility study on the deposit and the conditions of an agreement."

-- D. "To establish a National Council consisting of representatives of the State and civil-society organizations in order to have transparent mining operations on strategic deposits under public control, provide advice and assistance on agreements related to deposits of strategic importance, and to undertake independent monitoring on mining and tendering of such deposits; and to approve the National Council Charter."

-- E. "To grant companies that have operated no less than 15 years the preemptive right to conduct their activities in areas adjacent to the deposits mined by such companies."

INDUSTRY VEHEMENTLY OPPOSED

¶3. (SBU) Western mining companies and many domestic mining firms have not been shy in conveying to Post their vehement, angry opposition to these amendments. They argue that the amendments are poorly drafted and unclear. For example, Provision A does not clearly define what would or would not be considered "strategic,"

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giving the GOM and Parliament almost unlimited authority to declare any sort of deposit "strategic" -- meaning that the state gets 51% right off the top. Mining companies ask: What constitutes a national-security issue as far as a mining asset is concerned? What sort of social and (or) economic impact would trigger a strategic designation? These questions have lingered since the concept was first included in the 2006 Law, and the latest amendments fail to clearly define the concept in a way that would enable investors to gauge the likelihood of the state making a claim on a deposit.

¶4. (SBU) Adding to the complexity, Provision B seems to provide for non-state majority ownership of strategic deposits as long as the owner is Mongolian: GOM, Mongolian legal entity, or Mongolian citizen. However, as local attorneys have pointed out, current law requires all mining-license holders to be Mongolian legal entities, and allows foreign firms to register as Mongolian legal entities for this purpose. These amendments do not disqualify any Mongolian legal entity from owning a strategic deposit, no matter nationality of the ultimate owner, which seems to fly in the face of the intent to assure Mongolian control over the mining asset. (Note: A reliable Embassy contact explained that this provision represents something of an uneasy compromise between the ruling party and the opposition, both of which have agreed to support the legislation at the Parliament session that opens on March 25. The opposition Democratic Party (DP) favors majority non-state involvement/ownership, so long as it is Mongolian citizen or legal entity involvement. Given the past behavior of Mongolian mining interests in complying with existing laws and regulations, the ruling Mongolian People's Revolutionary Party (MPRP) is less confident about allowing private Mongolian interests a seat at the table, and believes that state interests are better secured through direct state involvement. End Note.)

NO REFLECTION OF BEST PRACTICES

¶5. (SBU) According to international investors, the amendments do not reflect commercial best practices in any way, shape or form. Most Mongolian mineral deposits lack even the most basic infrastructure, forcing rights holders to expend significant resources to extract any deposit. The GOM relies on mining companies to supply much-needed resources and expertise, but at the same time seems

determined to limit their rights. Some GOM sources tell us that mining companies will be expected to finance the GOM's investment, but will not receive operational or managerial control commensurate with their contribution. Furthermore, companies have pointed out the GOM's inherent conflict of interest in regulating and enforcing mining, tax, environment, health and safety laws, while being the majority owner of an ongoing operation. Western firms have rejected the 51% claim outright as absolutely unworkable in its current form, claiming that they will not enter into any agreement under such conditions.

ADJACENT PROPERTIES

¶ 16. (SBU) Mining companies have also taken exception with the amendments' granting of exploration and mining rights on adjacent properties to holders of strategic deposits. They argue that this new power would give special rights to the holders of strategic deposits -- which under the proposed law could be a state-owned firm or a Mongolian-owned firm -- to take expropriate whatever land it wanted near any strategic deposit. GOM officials have been publicly asked by the business community whether adjacent holdings were at risk, and have stated categorically that exploration rights have been formally delineated and are not for the GOM's taking. This provision seems to contradict such statements.

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OPAQUE PROCESS

¶ 17. (SBU) The entirely un-consultative and un-transparent nature of the amendment process has come under heavy criticism. Both Post and businesses have gotten their hands on updated revisions of the amendments, but only in the strictest confidence from key contacts on the GOM minerals law working group who fear retribution from the GOM if their activity became public knowledge. Given the atmosphere, it has been impossible to verify whether the information we have been receiving is up to date and complete. As one long-time Mongolia-based mining expert noted, there still is no requirement that Mongolian legislation be publicly vetted.

COMPANIES DISCOURAGED; A FEW MINOR PLAYERS EXIT

¶ 18. (SBU) Many mining companies say these amendments have had the most discouraging impact on their investments to date. Generally, those already on the ground have not pulled out, but they have limited their exploration and development investments until matters clarify. Some prospective western players have decided to forego entry for now. One western equity investor told Commoft that it had cancelled plans to invest US\$100 million in a coal prospect because of this amendment process. The mine did not seem to be a strategic deposit, but with the amendments so vague and the GOM so inconsistent, the risk was too high. A few firms (Blue Rock and Fortress -- strictly protect) are selling out and departing for good.

RIO TINTO: 51% GOM STAKE A DEAL-KILLER

¶ 19. (SBU) For major players like Rio Tinto (RT), a 51% GOM stake would kill any deal, but RT tells us that rather than pulling out altogether now, they will move to care and maintenance operation (CMO) -- no mining activity, just barebones development -- until or unless the GOM provides terms that reflect commercial realities. RT tells us it has already canceled US\$400 million in contracts for equipment to be used at the massive Oyu Tolgoi (OT) copper and gold deposit, and that other cancellations will occur in upcoming months. This will cost RT and its partners sizable financial deposits in advance of fabrication and, more importantly, RT's place in the manufacturing cue. It may be two or three years for the firms to get their places back in line, at which point costs will almost surely have risen. For U.S. export interests, these cancellations may cost US\$200 million up front. Another victim of this amendment process is employment; the number of RT's OT-based

jobs has dropped from 1,500 employees a year ago to a 600-person skeleton crew.

LEGAL DEFENSE BEING PREPARED

¶10. (SBU) Although Mongolian law and the current amendments seem to allow for a CMO, RT and others fear that demagogic and populist politicians might use a CMO as an excuse to expropriate RT's mining licenses. Consequently, RT is preparing legal defenses allowed under their right to seek international adjudication and under the current Bi-lateral Investment Treaty between the U.S. and Mongolia.

¶11. (SBU) Rio Tinto's approach has been to talk softly in public, showing all due respect for Mongolian laws and customs, but to make clear in private that any mine must operate according to international best practices, which the GOM has said it wants to institute in Mongolia. As a carrot, if some solution could be found, RT has indicated a willingness to deliver advance payments to the GOM, in lieu of future revenues in the neighborhood of US\$120

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million. The GOM, Parliament and the various parties have already promised voters rewards from mining, and the advance payments would certainly be needed to honor election commitments (a point not lost on any of those involved in this dispute).

"LARGE AND IN CHARGE"

¶12. (SBU) The GOM and Parliament, and particularly powerful officials of the ruling MPRP, are anxious to show voters that when it comes to mining, they are "large and in charge." All regular Embassy contacts at the Ministry of Industry and Trade, the State Property Committee and the Prime Minister's Office have been blunt, emphatic, and consistent about the Bayar Government's aims in the run-up to the June 29 parliamentary elections:

-- Pass legislation that shows that this Government is decisive on issues of special interest to the public: mining, taxes, alcohol sales, etc.;

-- Prove that the MPRP loves the nation and will protect its interests against acquisitive foreign interests, especially those in the resource-extraction sectors;

¶13. (SBU) Consequently, our sources say, even if the GOM officials think a piece of legislation is poorly drafted and/or too nationalistic for commercial success, the MPRP will ram it through Parliament, regardless of immediate consequences to investors, public interest, or the long-term impacts on the sector, because it wants to win and thinks this sort of legislative activity is the path to electoral success. The sources add that this populist agenda is driven, in part, by the very real fear that without it, Mongolia's sovereignty would be jeopardized by China or Russia.

MPRP, DP REACH CONSENSUS

¶13. (SBU) The amendment debate has brought the MPRP and DP to a bipartisan commitment to pass the amendments in the upcoming Parliament session. During the week of March 10, DP Chief Elbegdorj appeared on TV with PM Bayar, and both announced that their parties would join forces to pass the mining amendments. This agreement headed off what could have been a murderous debate in Parliament. MPs might otherwise compete against each other to woo voters with offers of cash and development (while hurling charges that their opponents were selling out the nation). Seasoned observers of Mongolian politics noted that regardless of whether the uncommon bipartisanship favored one party or the other, it was probably better for both sides to show that on this issue, they could work together for Mongolia rather than rehash charges that might inspire voters to curse both parties.

SOME DP MPS MIGHT NOT PLAY BALL

¶14. (SBU) However, post has received information from a dissident element within the DP, who claims that not all members will support Allegory's bipartisan approach. They apparently do not like ceding leadership on mining to the MPRP, which Elbegdorj seems to have done by agreeing to support Bayar's amendments. In addition, they believe that the 51% figure is anti-business and un-workable, and want to find a way to short-circuit next week's legislative process.

They have apparently not spoken out against the bill for fear of being labeled as traitors to Mongolia's national interests. They say their strategy will be to question each and every word, figure and sentence, consuming so much time that the bill will not be able to pass during the session.

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COMMENT

¶15. (SBU) 'Tis the (election) season, and the GOM and Parliament seem hell-bent on getting the amendments passed. We see no indication that any amount of criticism from mining companies or the diplomatic corps would deter the MPs from the swift completion of their appointed rounds. For the international community, post believes the proper course would be to encourage the GOM and Parliament to proceed with great care and caution - following international norms and best practices, but the sad political reality is that the current climate favors reckless speed, rather than thoughtful consideration. When the subject has been raised with GOM and Parliamentary interlocutors, Post has calmly but firmly noted that the inequitable, anti-business path down which Mongolia's mining sector is headed will not yield the development and revenues that Mongolian so desperately needs. In addition, post has been working with GOM and Parliament officials, providing information on how the USG deals with similar issues in its own mining sector. Although post has not sought out opportunities to comment on these amendments, we believe when asked we can not remain silent but reflect back what the business community has said about risks and damage done to international corporate perceptions of Mongolia's business climate. One component of this approach has been efforts by the Department of Interior's Bureau of Land Management (BLM) to consult with those Mongolians charged with crafting the amendments. These expert-to-expert consultations (via Digital Video Conferencing hosted by post) have gone some way toward correcting the willful mischaracterizations of USG mining practices used by some Mongolian officials and politicians to justify these amendments. (Post thanks BLM for these efforts and for future support.) Post will leverage these and other consultations to create relationships with those Mongolians whose opinions have affected this set of amendments and will likely affect future legislation and regulation, laying the groundwork for reconsideration of a more commercially-based approach to regulating the sector after the 2008/2009 political season. END COMMENT.

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